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PROMUS MANAGEMENT

Hold Onto Your Seats

Commercial real estate practitioners are jumpy, at best, these days. With Lehman having gone bankrupt, the Merrill Lynch acquisition by BofA and AIG in parts, everyone wants to know what happens to their commercial real estate holdings? Here's what we've come up with:

- Between whole loans, conduits and direct real estate investments, Merrill was exposed to about \$18 billion in commercial loans. Given the perception of risk now associated with CMBS, Bank of America can be expected to try and dump Merrill's portfolio via the auction block. As of March, the firm held CMBS bonds worth \$5 billion in its U.S. portfolio.

According to Suzanne Mulvee, senior real estate economist with Property & Portfolio Research (a Boston-based real estate research and portfolio strategy firm), "The pressure to sell is bound to cause prices to drop in the commercial real estate market." This will likely worsen the impact on the U.S. economy at large.



"If companies are forced to de-leverage, it takes a mild recession and pushes it deeper," says Mulvee. "If corporations de-leverage, we are losing jobs, and if we are losing jobs, the demand for real estate is falling."

Given the recent wild swings in every segment of the financial markets, and the Treasury Department's frantic efforts to support any and every financial instrument in sight, it is increasingly impossible to dare a guess as to how much of a discount the banks will have to accept if they sell. However, as Mulvee observes; "it's not a good thing."

- Lehman, too, is expected to find their \$32.6 billion in commercial real estate assets being auctioned off, according to David Akeman, director in the capital markets group of Stan Johnson Company, a Tulsa, Okla.-based commercial real estate investment firm.

Lehman's \$32.6 billion commercial portfolio includes \$17 billion is located in the United States. Its domestic CMBS holdings make up between \$600 million and \$900 million. About 11 percent of its portfolio is devoted to retail

Lehman's plans prior to filing for bankruptcy last month were to spin off its commercial real estate portfolio into a stand-alone, publicly-traded entity. Creating the new company, named Real Estate Investments Global, would have allowed the bank to avoid a forced fire sale.

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However, given its September 14 bankruptcy filing, it is increasingly unlikely that Lehman will be allowed to spin off one of its divisions, according to Adam B. Weissburg, partner with Cox Castle Nicholson LLP, a Los Angeles-based real estate law firm.

Says Merrie Frankel, vice president with Moody’s Investors Service. “We are waiting to see where all this falls out.” From all indications, even Lehman employees don’t know at this point what’s going to happen with the firm’s real estate portfolio.

- AIG’s situation gives more reason for hope, with the Federal Reserve recent infusion of \$85 billion loan in exchange for a substantial ownership stake in the company. This cash infusion is expected to help the company survive the credit crisis, and AIG has already begun selling off assets and changing its corporate structure in significant ways.

However, given their \$60 billion position in the credit default swaps market—some of which is tied to CMBS and their \$16 billion in international real estate assets, AIG’s commercial exposure is difficult to pin down.

Says Jon Southard, principal and director of forecasting with CBRE/Torto Wheaton Research, a Boston-based research firm; “I think it’s the government’s responsibility to try not to put those assets on the market at once, just because there is not enough capital out there to purchase them all at the same time.”

Despite everything being so shaky, NAR Economist Lawrence Yun believes “It is safe to say we have hit bottom in home sales (which have been essentially stable for 12 months).” And since commercial markets typically lag behind residential markets, we’ve probably got another 18 months of rough stuff before coming out of the tunnel.

Green Laws Impact Commercial Real Estate

New development and commercial real estate sales are slower, but California’s still prime property in which to invest. Lawmakers realize development here will never stop, and are hard at work to ensure future development and renovations have as little impact to the environment as possible.

Here are just a few of the types of “green” building/community legislation currently being considered as of this writing:

- US House Resolution (HR) 6078 (The Green Resources for Energy Efficient Neighborhoods (GREEN) Act of 2008) would encourage the development, renovation, and sales of energy efficient homes and businesses by offering incentives to lenders who issue mortgage benefits for such buildings.
- California Assembly Bill (AB) 1065 would require “zero net energy” usage for both residential and commercial buildings by 2020 and 2030, respectively. (A “zero net energy” building is one that produces at least as much energy as it consumes over the course of a typical year.)
- California Assembly Bill (AB) 2939 would allow cities and counties to impose stricter “green” building codes than those currently imposed by the California Green Building Standards Code.
- California Assembly Bill (AB) 2030 would require any new non-residential construction commencing on or after January 1, 2030, to be “zero net energy” buildings.
- California State Senate Bill (SB) 375 - Awaiting Governor Schwarzenegger’s signature as of this writing, SB 375 is yet another unprecedented piece of legislation that would curb global warming, this time, by discouraging urban sprawl, and instead, facilitating more compact development, efficiently linking homes, transit, and businesses.





Many of these bills have surfaced in the wake of AB 32, otherwise known as the California Global Warming Solutions Act. Signed in 2006 by Governor Arnold Schwarzenegger, AB 32 is just now becoming a reality. A draft implementation plan was released in June by the California Air Resources Board, and it outlined strategies to reduce greenhouse gases in the state to 1990 levels by 2020. AB 32 has once again thrust California into the limelight as a leader in the fight against pollution due to global warming.

San Francisco has already taken many of these types of “green” legislation to heart, and made headlines of its own with Mayor Gavin Newsom’s recent approval of the city’s groundbreaking green building ordinance. This imposes strict new requirements on new construction and renovations. These requirements make San Francisco the city with “the most stringent green building requirements in the nation.”

Food for Thought
"Perhaps it's time America was run like a business."
-- Donald Trump

Growth restrictions in Southern California, due to the water crisis, will also be a serious consideration. In an August meeting hosted by the San Diego/Tijuana chapter of the Urban Land Institute, county experts and various development groups agreed that restrictions on water use, and thus, development, loom large on the horizon. Two pieces of legislation passed in 2001 are already in place to carry out such restrictions. SB 610 and SB 221 both require developers to identify adequate water sources before development can proceed.

Given this movement throughout the state and the nation, San Diego owners should plan to be able to address much of this legislation shortly.

Have We Hit Bottom Yet?

The San Diego Business Journal reports that lending for the SBA's 504 program, used to buy commercial real estate, is down by 16 percent through mid-September. "But in the Western region, which includes California, Arizona, Nevada and Hawaii, it's down 25 percent" says the report.

Is there only bad news? Not necessarily, since Lehman and Merrill Lynch - both now in trouble - each only made one loan this year. And WAMU did less in dollar volume than those two combined.

Kurt Chilcott, president of CDC Small Business Finance in San Diego, observes "A lot of people are on the sidelines, waiting to see if we've hit the bottom or if this is a good time to move forward." Yes, that sounds about right to us.

About Promus Management

We satisfy the nation's most demanding commercial property owners with our unique combination of skills, blending national credentials in commercial building management with an unprecedented local commitment to service.

We recognize building owners need to know that everything necessary to ensure a property's success has been anticipated and will be handled properly. From due diligence to leasing, management to upkeep, we recognize the importance of communications and prompt attention to both client and tenant needs.

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